BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

March 16, 1978

CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida ALB

Attached is a memorandum prepared by the Board's staff, dated March 15, 1978, and entitled "Bearer Certificates of Deposit." This memorandum addresses certain questions raised during the Committee's discussion at its meeting of February 28, 1978.

Attachment

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 15, 1978

To Mr. Kichline

Subject: Bearer Certificates of Deposit

From Messrs. Cole and Boltz

At its last meeting, the Federal Open Market Committee discussed the issuance of small-denomination negotiable certificates of deposit in bearer form. This memorandum addresses certain questions raised by the Committee concerning such certificates.

BACKGROUND

For several weeks, there has been a spreading practice on the part of some banks of issuing negotiable CDs in bearer form in denominations as small as $25 to $100. Certificates issued in bearer form, heretofore, have almost universally been issued only in large denominations ($100,000 and over). The issuance of small bearer certificates has occasioned some concern on the part of the Treasury, the IRS, and others regarding the potential for tax evasion associated with such instruments. In this connection, small-denomination bearer CDs were the subject of a hearing conducted by the House Commerce, Consumer, and Monetary Affairs Subcommittee of the House Government Operations Committee on March 9. In addition, it should be noted that the Pennsylvania Secretary of Banking acted on February 24 to prohibit the sale of small-denomination bearer CDs by State-chartered banks in Pennsylvania.

Since bearer certificates are specifically exempted from the reporting requirements issued by the Secretary of the Treasury pursuant to the Bank Secrecy Act, there is no requirement that issuing banks maintain a taxpayer identification number with respect to such certificates.[1/] In addition, under regulations promulgated pursuant to Section 6049 of the Internal Revenue Code, there is no requirement that the interest earned on negotiable time deposits issued in bearer form be reported by the bank to the IRS.[2/] These exemptions to the general reporting requirements were apparently granted in recognition of the fact that bearer CDs are generally issued in large denominations and subsequently traded in the secondary market so that all recipients of interest earned are not easily determined. It has been noted, in this connection, that bearer CDs in small denominations, even though negotiable, are likely to be held to maturity by the original purchaser.

The advertising of these small-denomination CDs by some banks has stressed the fact that the amount of the deposit and the interest earned are not reported by the bank to the IRS. In fact, several banks are calling these instruments "honor bonds" since the depositor is "honor bound" to report interest earned to the IRS. Other advertisements have stressed the privacy offered by such CDs, likening them to Swiss bank accounts. One bank has even advertised that these CDs could be used like money to pay for goods and services.

SURVEY RESULTS

In early March, the staffs of the Federal Reserve Banks were asked to investigate the prevalence and characteristics of bearer

1/ 31 CFR 103.34(a), Interpretation 8.
2/ 26 CFR 1.6049-2.

deposits in their Districts through contacts with commercial banks, State bank regulators, and managers of Federal Reserve branches. It was found that bearer deposits have gained prominence in only three adjoining States: New Jersey (where small-denomination bearer deposits originated a decade ago), Pennsylvania, and most recently Ohio. In these three States, our survey of member and nonmember banks found that there are slightly more than $100 million of such deposits. Elsewhere, relatively few or no banks were offering such deposits, and the bankers were generally either unaware of them as depository instruments or viewed them as unethical.

In Pennsylvania and New Jersey, there are currently about $90 million in bearer deposits at the 19 commercial banks offering them. The bearer deposits are predominantly one-year certificates with annual automatic renewal for 12 years and pay the ceiling rate on one-year time deposits of 6 per cent. Compounding interest over 12 years results in a doubling of the initial deposit, and in these two States the focus of advertising has apparently been on this aspect. However, in Pennsylvania, some banks recently began advertising the absence of a requirement to report interest earned on bearer deposits to the IRS. The Pennsylvania Secretary of Banking responded promptly by forbidding the continued sale of small-denomination bearer deposits by State-chartered banks after February 24, 1978.[1/] One national bank in Pennsylvania continues

1/ A similar series of events occurred in Nebraska where three banks began offering bearer deposits and advertising their secrecy aspects. The Nebraska State Banking Director admonished banks to begin recording the names of purchasers of bearer deposits, and two of the banks have since discontinued offering such deposits. The total volume of these deposits has reached $2 million at Nebraska banks.

to offer the instrument.

Two large holding companies in Ohio, which together control 58 banks located throughout the State and have combined assets of $4.5 billion, began offering bearer deposits this year. In six weeks, the banks have attracted over $15 million in such deposits, roughly evenly split between one and four-year certificates. In early March, one of the holding companies decided to stop advertising these deposits. Up to then, both it and the other bank holding company offering bearer deposits had emphasized in their advertisements that interest earnings would not be reported to the IRS. State banking regulators are not known to have taken any action.

Among banks not currently offering bearer deposits, several bankers in New Jersey, and especially in Ohio, reported that they planned to begin marketing bearer deposits in the next few weeks. More bankers have the matter under serious consideration. In both States, competitive pressure was most often cited as the factor influencing the decision to begin offering such deposits, and a few bankers said that they desired to meet a consumer need and broaden their consumer services.

REGULATORY FRAMEWORK

There is nothing in the Board's regulations that would prohibit a member bank from offering small-denomination negotiable CDs in bearer form. Both Regulations D and Q have traditionally defined the term "time certificates of deposit" to include either a negotiable or nonnegotiable instrument, and since 1936, the definition of "time certificate of deposit" has specifically included the words "negotiable or nonnegotiable instrument" to emphasize that CDs may be either negotiable or nonnegotiable. Such a definition, therefore, enables member banks to offer deposits in any denomination in bearer form. Similarly, there is no impediment to the issuance of small-denomination CDs in bearer form under regulations promulgated by the FDIC. It should be noted, however, that Federally-chartered savings and loan associations are limited in their ability to issue bearer time deposits. Under FHLBB regulations (12 CFR 545.1-5) negotiable CDs ("marketable certificates of deposit") may only be issued in denominations of $100,000 or more. Share certificates issued by Federal credit unions may not be issued in negotiable form since such share certificates can only be held by a credit union's members.

In the event that it should at some time be determined that Board action to prohibit the offering of small-denomination bearer CDs by member banks is appropriate, staff believes that the Board has adequate authority under section 19 of the Federal Reserve Act to amend the regulatory definition of the term "time certificate of deposit" to prohibit small-denomination negotiable instruments issued in bearer form. As an intermediate step, the Board might find advertisements that point up the tax evasion possibilities of such instruments objectionable as inaccurate or misleading under section 217.6(g) of Regulation Q. Such action has already been taken by the Comptroller against two national banks. However, staff believes that the problems posed by small-denomination bearer CDs could be appropriately handled by Treasury-IRS action to amend outstanding regulations to require the maintenance of taxpayer identification numbers and the reporting of interest earned on such instruments to the IRS. In this connection, on March 9, Treasury-IRS released a notice of proposed rule making which would amend its regulations to require the reporting of interest paid on CDs issued in bearer form in denominations of less than $100,000 (Attachment A). It is anticipated that this reporting requirement, which should become effective shortly, will lessen substantially the attractiveness of small-denomination bearer CDs, as has already been the case in Nebraska.

Attached are several advertisements concerning bearer CDs (Attachment B).

[4830-01]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

[26 CFR Part 1]

[LR-54-78]

INCOME TAX

Information Reporting Requirements for Bearer Certificates of Deposit

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to information reporting requirements. The regulations would enable the Internal Revenue Service to obtain information returns with respect to interest paid on certificates of deposit issued in bearer form. The regulations would apply to all persons carrying on the banking business and making interest payments on certificates of deposit issued in bearer form in denominations of less than $100,000.

DATES: Written comments and requests for a public hearing must be delivered or mailed by April 27, 1978. The amendments are proposed to be effective for payments of interest on bearer certificates of deposit made after March 13, 1978.

For certificates of deposit issued prior to this effective date, the identity of the person to whom the certificate was originally issued need not be supplied by the bank, if this information is unknown at the time the information return is made.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-54-78), Washington, D.C. 20224.

FOR FURTHER INFORMATION CONTACT:

Leonard T. Marcinko of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, D.C. 20224 (Attention: CC:LR:T) (202-566-3297).

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains a proposed amendment to the Income Tax Regulations (26 CFR Part 1) under section 6049 of the Internal Revenue Code of 1954. The amendment is proposed in order to require information reports for interest paid with respect to certificates of deposit in bearer form, and is to be issued under the authority contained in sections 6049 and 7805 of the Internal Revenue Code of 1954 (76 Stat. 1056, 26 U.S.C. 6049; 68A Stat. 917, 26 U.S.C. 7805).

EXPLANATION OF PROVISIONS

Section 6049 of the Code imposes an information reporting requirement on any person making payments of interest aggregating $10 or more to another person during any calendar year. In addition, section 6049 gives the Secretary of the Treasury or his delegate authority to require information returns on payments of interest aggregating less than $10 to any person during the calendar year.

Section 1.6049-2(a)(2)(ii) of the regulations currently excepts from the definition of interest for purposes of section 6049 interest paid on certificates of deposit issued either in bearer form or in an amount of $100,000 or more. Paragraph 2 of the proposed regulations would amend this definition of interest so as to except from the definition only interest paid on certificates of deposit issued in an amount of $100,000 or more.

Paragraph 1 of the proposed regulations would amend § 1.6049-1(a)(1) in order to impose a reporting requirement on persons carrying on the banking business who make payments of interest on certificates of deposit issued in bearer form. This reporting requirement would apply whether or not the amount of interest paid to any person during a calendar year aggregates $10 or more. For purposes of this reporting requirement for bearer certificates of deposit, § 1.6049-2(a)(2) of the proposed regulations provides that the term "interest" has the same meaning as in § 1.61-7 of the regulations. This is the case regardless of whether the "interest" is taxable to the payee in the year the information return is made.

The information return that would be required by this proposed amendment to the regulations must include, among other items, the identity of the person to whom the certificate of deposit was originally issued, as well as the identity of any person to whom interest is paid. However, paragraph 4 of the proposed regulations makes it clear that the statement to the payee of the interest reported shall not disclose the identity of the person to whom the certificate was originally issued (if a different person than the payee). Of course, in connection with the reporting of a payment of interest to a subsequent owner, no statement is required to be made to the person to whom a bearer certificate was originally issued.

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these regulations, consideration will be given to any written comments that are submitted (preferably six copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

DRAFTING INFORMATION

The principal author of these proposed regulations was Leonard T. Marcinko of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and the Treasury Department participated in developing the regulation, both on matters of substance and style.

PROPOSED AMENDMENTS TO THE REGULATIONS

The proposed amendments to 26 CFR Part 1 are as follows:

PARAGRAPH 1. Paragraph (a)(1) of § 1.6049-1 is amended by inserting immediately after subdivision (v) the following new subdivision:

§ 1.6049-1 Returns of information as to interest paid in calendar years after 1962 and original issue discount includible in gross income for calendar years after 1970.

(a) *Requirement of reporting*—(1) *In general.* * * *

(vi) Every person carrying on the banking business who makes payments of interest to another person (whether or not aggregating $10 or more during a calendar year) with respect to certificates of deposit issued in bearer form (other than such certificates issued in an amount of $100,000 or more) shall make an information return on Forms 1096 and 1099-CD for such calendar year. The information return required by this subdivision for the calendar year shall show the following:

(*a*) The aggregate amount of interest paid with respect to the certificate of deposit;

(*b*) The name, address, and taxpayer identification number of the person to whom the interest is paid;

(*c*) The name, address, and taxpayer identification number of the person to whom the certificate was originally issued;

(*d*) The amount of interest with respect to the certificate attributable to each calendar year falling within the term of such certificate; and

(*e*) Such other information as is required by the form.

* * * * *

PAR. 2. Paragraph (a)(2) of § 1.6049-2 is amended to read as follows:

§ 1.6049-2 Interest and original issue discount subject to reporting.

(a) *Interest in general.* * * *

(2) Interest on deposits (except deposits evidenced by negotiable time certificates of deposit issued in an amount of $100,000 or more) paid (or credited) by persons carrying on the banking business. In the case of a certificate of deposit issued in bearer form, the term "interest", as used in the preceding sentence and in paragraph (a)(1)(vi) of § 1.6049-1, has the same meaning as in § 1.61-7 (regardless of whether taxable to the payee in the year the information return is made).

* * * * *

PAR. 3. Paragraph (c)(2) of § 1.6049-2 is amended to read as follows:

§ 1.6049-2 Interest and original issue discount subject to reporting.

* * * * *

(c) *Original issue discount—*(1) *In general.* * * *

(2) *Coordination with interest reporting.* In the case of an obligation issued after may 27, 1969 (other than an obligation issued pursuant to a written commitment which was binding on May 27, 1969, and at all times thereafter), original issue discount which is not subject to the reporting requirements of paragraph (a)(1)(ii) of § 1.6049-1 is interest within the meaning of paragraph (a) of this section. Original issue discount which is subject to the reporting requirements of paragraph (a)(1)(ii) of § 1.6049-1 is not interest within the meaning of paragraph (a) of this section.

* * * * *

§ 1.6049-3 [Amended]

PAR. 4. Paragraph (a) of § 1.6049-3 is amended by adding the following sentence at the end thereof: "References in this section to Form 1099 shall be construed to include Form 1099-CD, except that in applying paragraph (b)(2) of this section no information relating to the person to whom the certificate of deposit was originally issued shall be disclosed to another person to whom the payment of interest is made."

JEROME KURTZ,
Commissioner of Internal Revenue.

[FR Doc. 78-6506 Filed 3-9-78; 8:56 am]

Attachment B

BancOhio's new Negotiable Bonds double your money in 12 years.

• Guaranteed High Yield
• Easy to Buy and Transfer

The new BancOhio Negotiable Bonds are a safe investment for the future, and are available in two forms: A one-year bond that pays 6% annual interest (6.27% when compounded daily); a four-year bond that pays 7.25% (7.63% when compounded daily).

Either bond can be purchased in $100 multiples up to $10,000 per bond, with a minimum of $100 for a one-year bond and $1,000 for a four-year bond. When left to renew, they will earn interest at the guaranteed rate for up to 12 years. In that time, you'll more than double your money with either bond.

Other features of BancOhio Negotiable Bonds:

- **NO IRS 1099** is issued by the bank, so you report the interest earned;
- **Like cash,** they can be transferred easily without notifying the bank;
- **They're easy to buy** — no Social Security number, name or address is required.

The new BancOhio Negotiable Bond is just one of the wide variety of savings plans we have to meet any savings goal. Select a 5% savings account, ideal for money you might need immediately. Or choose a 5½%, 90-day account. Our wide selection of Pacesetter Savings℠ certificates is designed for longer-term investment. For example, you can earn as high as 7.5% annual interest (yielding 7.9% when compounded daily) on minimum deposits of $1,000 for 6 years. Interest is paid annually.

Contact any BancOhio office for more information on our new Negotiable Bonds, and we'll also help you plan the best way to reach your savings goals. **At BancOhio, we want to help you more.**

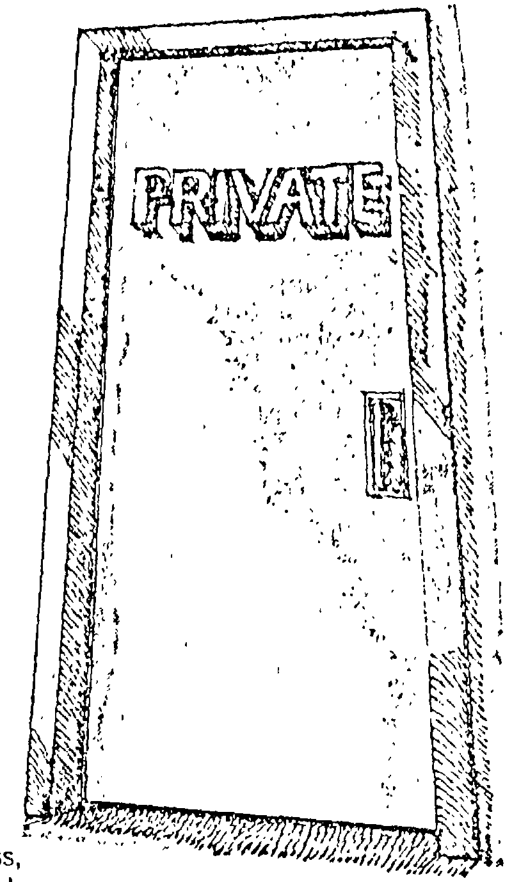
Federal regulation requires that interest on time deposits redeemed prior to maturity will be recomputed at the prevailing regular savings account rate, less 90 days interest.

BancOhio
Capital National Bank

Pacesetter Savings is a service mark of BancOhio Corporation and BancOhio banks.

Member FDIC

Introducing State National Bank Numbered Bonds...



your privacy is guaranteed!

SNB Numbered Savings Bonds are issued by Serial Number only, TO PROTECT YOUR PRIVACY! If you believe your savings should be your business, SNB Numbered Bonds are for you. You can buy as many as you want, in multiples of $100. They're perfect as gifts because no transfer notice is necessary —no names, no notice. SNB Numbered Bonds pay 6% interest per year. The Bonds mature one year from the date of purchase and can be cashed in anytime during the ten days thereafter. If you don't cash them in, they automatically renew every year, earning the same high 6% interest guaranteed up to 12 years. Caution: SNB Numbered Bonds should be treated like money and since ownership can't be traced, we suggest you keep them in a safe place. Remember, if you think your savings should be your business —we think SNB Numbered Bonds are for you— even though you're only a number to us. SNB Numbered Bonds will be issued only at the Bank's Headquarters, 11616 Rockville Pike (South of Montrose Road), Rockville.

State National Bank

Deposits Insured to $40,000 by FDIC
Member Federal Reserve System
NOTE: Federal Regulations require substantial penalties for withdrawal prior to maturity of SNB Numbered Bonds which are Negotiable Bearer Time Certificates of Deposit.

Any single currency transaction in excess of $10,000 must be made in compliance with the Bank Secrecy Act.

Phone: 881-7000

ꞏ Honor Bonds are "bearer bonds", the only record the bank keeps · bond serial number and the amount. That means the bond ıe transferred from one owner to another— .ke cash—without notifying the bank.

·r Bonds can be transferred ı one.

. ı be used as gifts or to pay debts Upon ation and surrender of the bond by the he bank will pay the face amount, along :umulated interest, during a ten-day . ıion period at maturity (annually on one- .onds and each four-years on four-year ; Final maturity occurs at the end of ears and the bond earns no additional · rom that time on. Honor Bonds may be : anytime at any of our banking offices, ! to federal regulations covering early : ion *

The Bank will not issue an IRS 1099 form.

Since no name appears on the bond and no customer identification number is required, the Honor Bond you buy is completely anonymous. For that reason, no 1099 tax reporting form can, or will, be issued by the bank. The person holding the bond is honor bound to report the interest received *(Because the bank keeps no records, we recommend you keep your Honor Bonds in a safe deposit box)*

They're easy to buy.

Both types of Honor Bonds can be purchased in one hundred dollar multiples up to $10,000 per bond with a minimum of $100 for the one-year and $1,000 for the four-year certificate. The two bonds work under slightly different ground rules.

As its name suggests, the one-year bond matures annually. Unless redeemed, it will automatically renew each year and continue to earn interest for a period of twelve years. That means, from the first anniversary of its purchase on through the twelfth, you can redeem it on any anniversary date for the face amount and all interest earned to date. Or you can leave it in the bank and let the interest accumulate. After twelve years, the final maturity date, the bond stops earning interest.

The four-year bond matures in four years. It too, if not redeemed, will automatically renew and continue to earn interest for two additional four-year periods. By law, the four-year bond can earn a higher rate since it has a longer maturity.

NOTE: The anniversary is determined by the date of original purchase from the bank, not when the "bearer" acquires it.

They're as good as gold.

Honor Bonds provide a unique savings opportunity First of all, the interest rates paid on the two types of Honor Bonds are the highest permitted by law and the interest is compounded daily. The face value of the certificate remains unchanged. You don't have to listen to the radio or read small print in a newspaper to find the asset value of your investment The interest rate printed on the Honor Bond is positively fixed as far as twelve years into the future. There's no guess work, no questions about future earnings, no changing conditions to consider— the bank will honor the Honor Bond as agreed for the face value plus interest. That's a guaranteed investment. It's even insured by the FDIC like all other bank deposits.

Mail Order Form along with your check to:

City National Bank & Trust Company
Attention: Time Deposit Department
P.O. Box 1347
Columbus, Ohio 43216